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Impact of Covid-19 on the banking sector

November 2020

Creating Opportunities

Agenda

01 Policy measures adopted

02 Early impact on financial fundamentals

03 Short and medium term outlook

Summary

01 A swift and coordinated response from monetary, fiscal and regulatory authorities has been key to address the consequences of the COVID crisis. These measures (heterogeneous by countries) have supported credit growth and have mitigated the initial negative impact on the economy (and also on the banking sector). **A premature withdrawal is a risk to the recovery.**

02 How has the banking sector entered -and is withstanding- the shock? a) **Adequate efficiency levels** driven by lower costs; b) Weak profitability, especially in developed countries; c) There are no signs of deterioration in asset quality yet despite large loan-loss provisions in DM; d) Capital indicators are sound; and e) Abundant liquidity and cash hoarding. **How countries deal with private sector indebtedness will be key for the aftermath of the COVID crisis.**

03 Post-COVID, we assess the relevance and impact on the banking sector of 7 key trends: a new monetary policy, digitalization, regulation, economic growth, new entrants, competitive landscape and government support. The evolution of these factors and the intensification/reduction of their underlying trends will identify post-COVID winning strategies which we summarize in 4 points: a) digitalization; b) adapt to clients' needs; c) increase efficiency; and d) revenue diversification. **The regulatory landscape and how institutions deal with these trends will be key for the future.**

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01

Measures adopted to cope with Covid-19 Crisis

Unprecedented coordinated policy response

Fiscal Policy

Strong and swift reaction (no other way once activity broadly stops due to need to deal with health concerns and confinement periods) **but there is a legacy being built: higher deficits and public debt**

Monetary policy

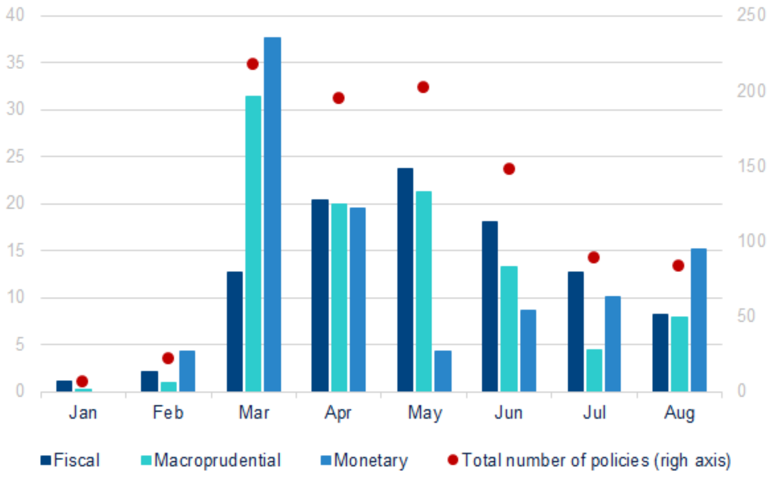
Further unconventional measures (as a backstop for financial markets as well as to ensure credit provision to households and businesses) **in Developed countries but Emerging countries are also cutting rates and testing QE**

Regulatory measures

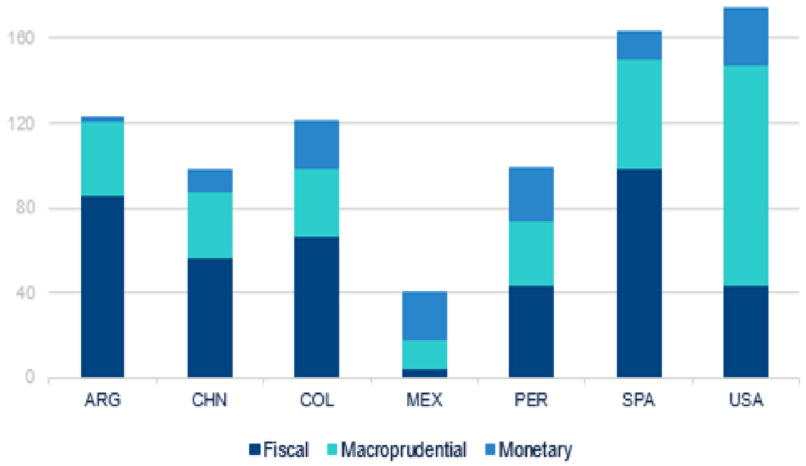
Focus to **support the flow of credit** to the economy, **mitigate operational and financial risks for the banking system** and **increasing operational capacity** to respond to short-term financial stability priorities

When, what and who is taking action?

COVID-19 PUBLIC POLICIES PER MONTH
(AS % OF TOTAL NUMBER OF POLICIES FOR EACH TYPE)

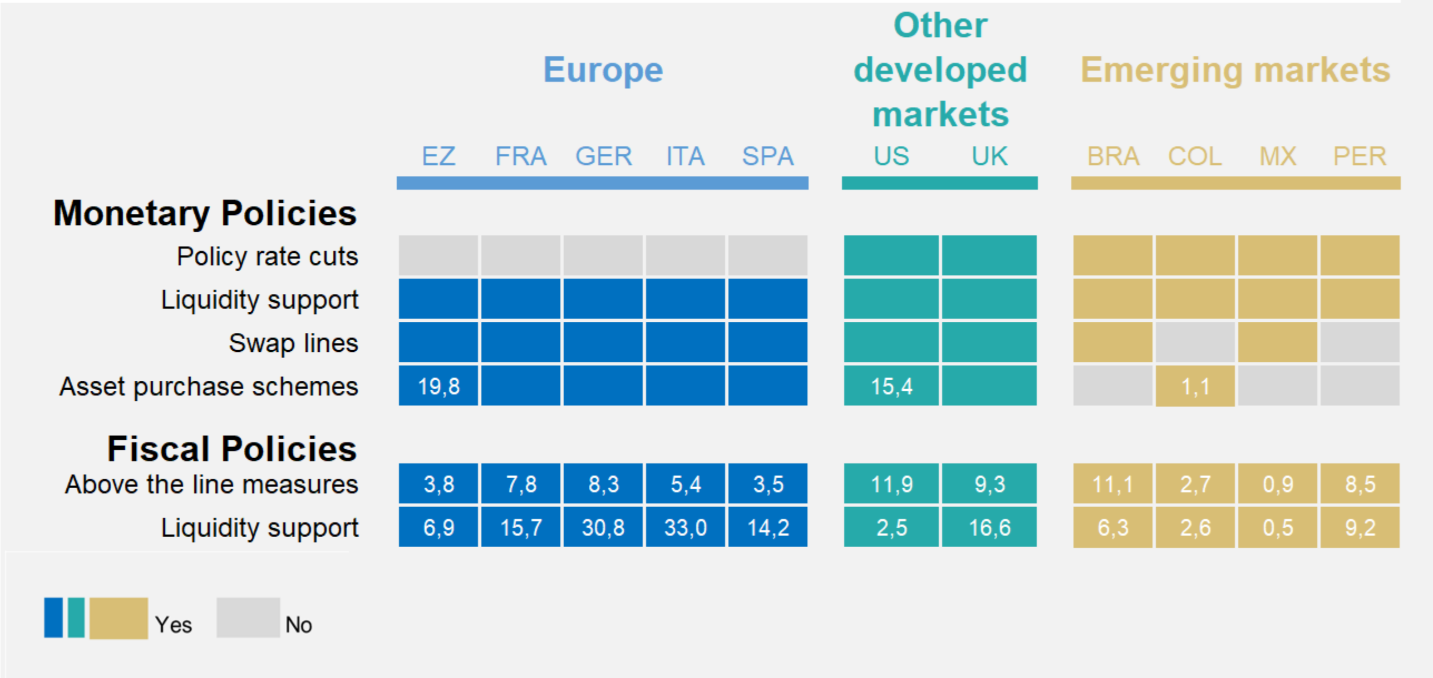


COVID-19 PUBLIC POLICIES PER COUNTRY
(NUMBER OF TOTAL POLICIES IN EACH COUNTRY)



Source: BBVA Research , Yale's Covid-19 Tracker and OECD

Fiscal and Monetary policy Measures in Response to the COVID-19 Pandemic



Numbers mean fiscal measures as % GDP
*In the EZ the ECB has reduced the cost of funding through lower cost of TLTROs

Source: IMF and BBVA Research

Authorities’ response varies across countries

MAIN BANKING MEASURES ADOPTED BY COUNTRIES

		Government Credit Guarantees Plan	Moratoriums		Additional measures for firms	Additional measures for households	Measures for banks		
		over GDP	over total credit portfolio	type			Credit loss provisions special treatment	Capital reliefs	Liquidity reliefs
Europe	France	14%	n.a.	mandatory	✓	✓	✓	✓	✓
	Germany	25%	n.a.	mandatory	✓	✓	✓	✓	✓
	Italy	31%	23%	mandatory	✓	✓	✓	✓	✓
	Spain	11%	5%	mandatory	✓	✓	✓	✓	✓
Other developed countries	UK	15%	na	mandatory	✓	✓	✓	✓	✓
	US	3%	5%	mandatory	✓	✓	✓	✓	✓
Emerging countries	Brazil	1%	22%	mandatory	✓	✓	✓	✓	✓
	Colombia	5%	43%	mandatory	✓	✓	✓	✗	✗
	Mexico	0,0%	19,5%	optional	✗	✗	✓	✓	✓
	Argentina	0,4%	n.a.	mandatory	✓	✓	✓	✗	✓
	Peru	9%	29%	optional	✓	✓	✓	✗	✗

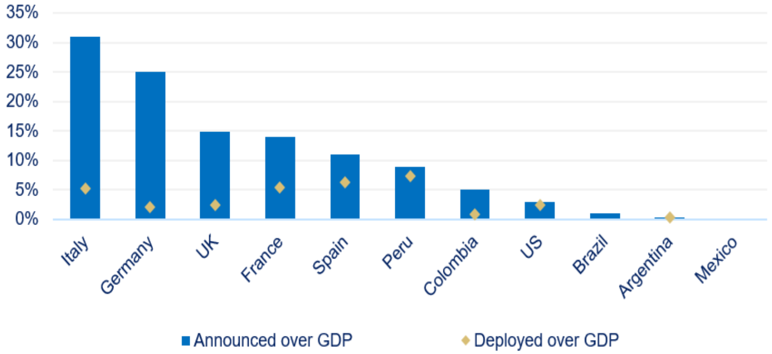
US and Spain hold a 5% of payment holidays or moratoriums over total credit portfolio. Conversely, Peru and Colombia are on the upper bound. Most of these moratoriums have expired or are close to, soon which will show the “real impact” of Covid crisis on the banks’ balance sheets.

Note: Measures for firms and households refers to other measures additional to credit guarantees and moratoriums such as tax delays or cancelations, rental assistance, pension withdraws, etc. Data of moratoriums as of July for Colombia and Mexico and September for the rest of countries. Some governments directly funded firms by their own developed banks (eg. BPI in France); these figures are not included on the table)
Source: BBVA Research based on Central Banks, Governments

Design of public guarantees and moratoria will have different impacts on the banking sector

CREDIT GUARANTEE SCHEMES

(% GDP)



Source: BBVA Research based on Central Banks, Governments

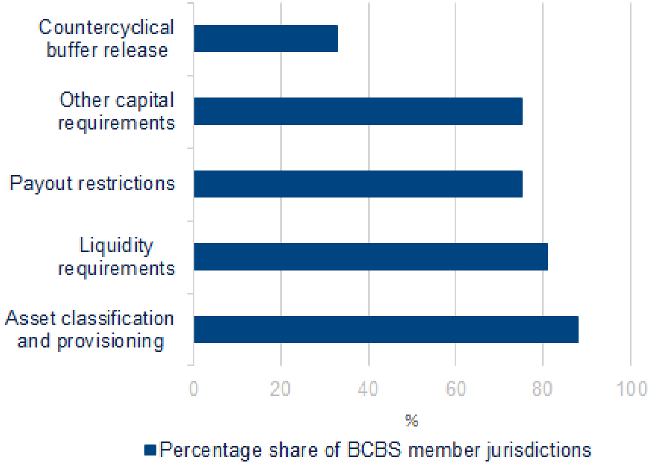
GOVERNMENT CREDIT GUARANTEES:

- Package size vs what was deployed; what does it mean?
- Guarantees offered: from 60% to c.100% (sector and size)
- Duration to minimize economic damage...but no free lunch
- Moratoriums:
- Decide how strict eligibility criteria is (scope vs payment culture)
- Mandatory or optional -leaving the criteria to banks-
- Economic conditions: delay of principal, interest or both
- Duration, longer terms may hamper the return to outstanding payments

Although some Governments approved huge amounts of credit guarantees, deployed -or mobilized- funds do not exceed 8% of GDP in any case

Changes in regulatory framework have been credit supportive

USE OF PRUDENTIAL MEASURES
(% OF BASEL MEMBER JURISDICTIONS)



Source: Basel Committee on Banking supervision; BIS calculations

- Borrower relief measures have a risk-reducing regulatory treatment:
  a) apply relevant sovereign risk weight for loans with sovereign guarantee;
  b) exclude payment moratorium periods from default / NPA definition;
  c) no automatic categorization of loans as forborne
- Amended transitional arrangements for regulatory capital treatment of expected credit loss accounting (add-back up to 100% of transitional adjustment to CET1 capital in 2020 and 2021).
- Regulatory flexibility maintaining sound capital levels: reduction in countercyclical buffers and waivers on capital and liquidity. Dividend and buyback share programs restricted in order to preserve capital.
- Postpone or revised implementation timeline of ongoing regulation: BIS III standards, revised G-SIB framework…
- Additionally, some aspects of supervisory and reporting activity have been reduced or at least postponed.

A timely exit from these regulatory relief measures is necessary to avoid a cliff effect

Assessment of main impacts and challenges

Impact on the banking sector

	POSITIVE	NEGATIVE	CHALLENGES
Monetary policy	Low financial tensions and help financial stability	Lower for longer interest rates: pressure on banking revenues	Scale-down of unconventional measures
Credit guarantee and moratoriums	Burden-sharing. Moderation of dramatic increase in bank losses	Lack of visibility around borrower's' financial health	Execution of guarantees / phase out of support measures. Support to zombie firms. Credit crunch when lifted
Regulatory framework	Mitigate financial impacts and alleviate operational burden. Regulation flexibility	Lack of transparency; Difficult balance between financial stability and regulatory forbearance	Financial stability implications; Too early temporary prudential treatment withdrawal?

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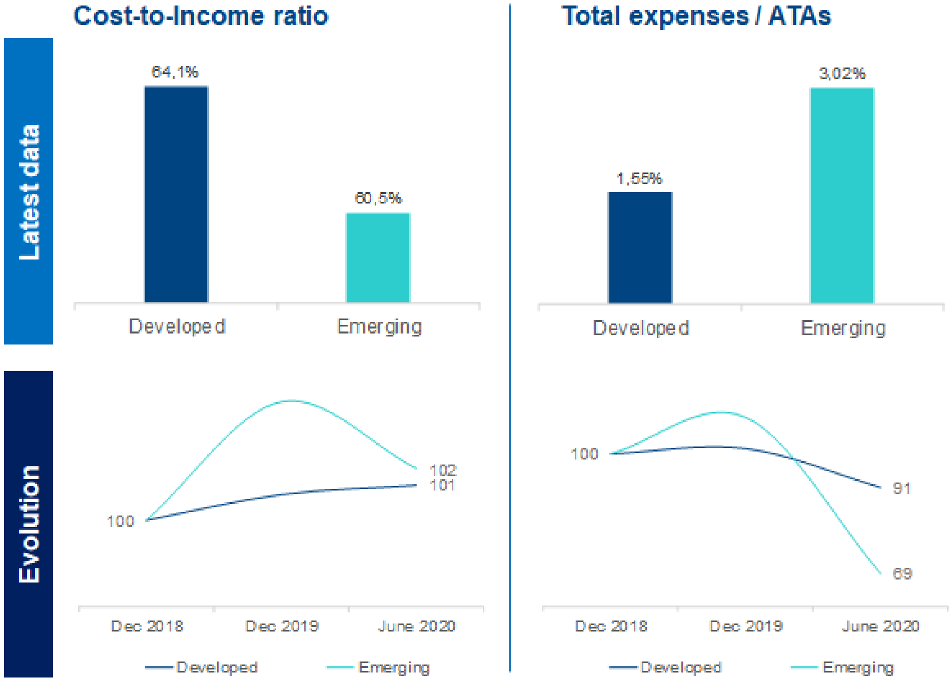
02

Early effects of the COVID crisis on the banking system

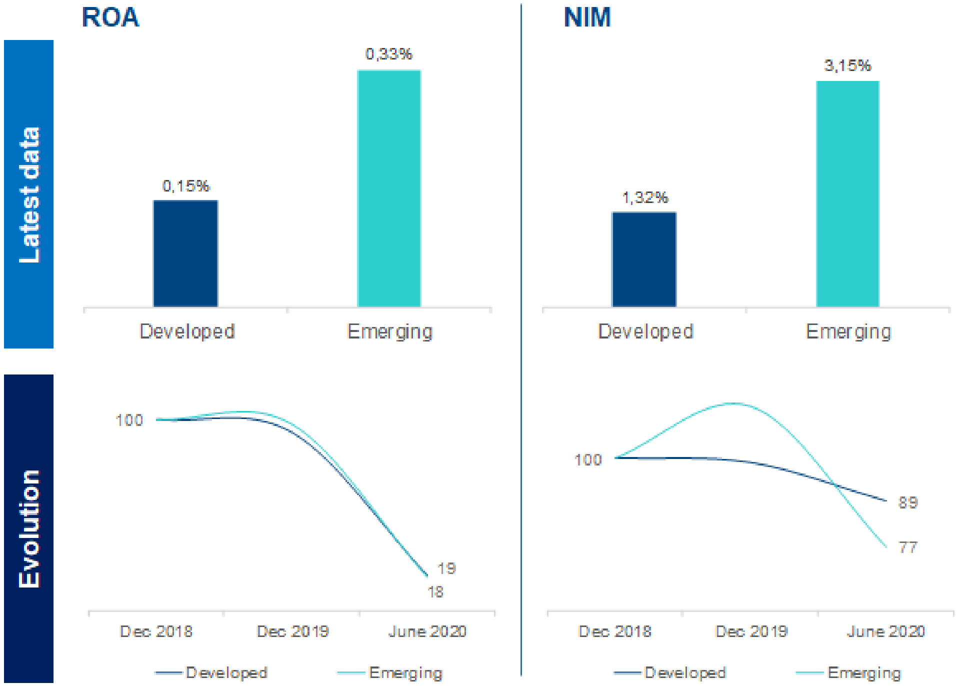
Efficiency improved as OPEX have been cut in H1



- Similar cost-to-income ratios; slightly better in emerging countries.
- Emerging countries' cost structure is twice as heavy as that of developed countries (even including USA, whose ratio is way higher than in European countries).
- In most cases, cost control has been reinforced in 1H20.

Developed: Spain, France, Germany, Italy, US and UK. Emerging: Colombia, Mexico, Peru, Turkey and Brazil. 5 largest banks in each country on a consolidated basis
Source: BBVA Research based on Bankscope

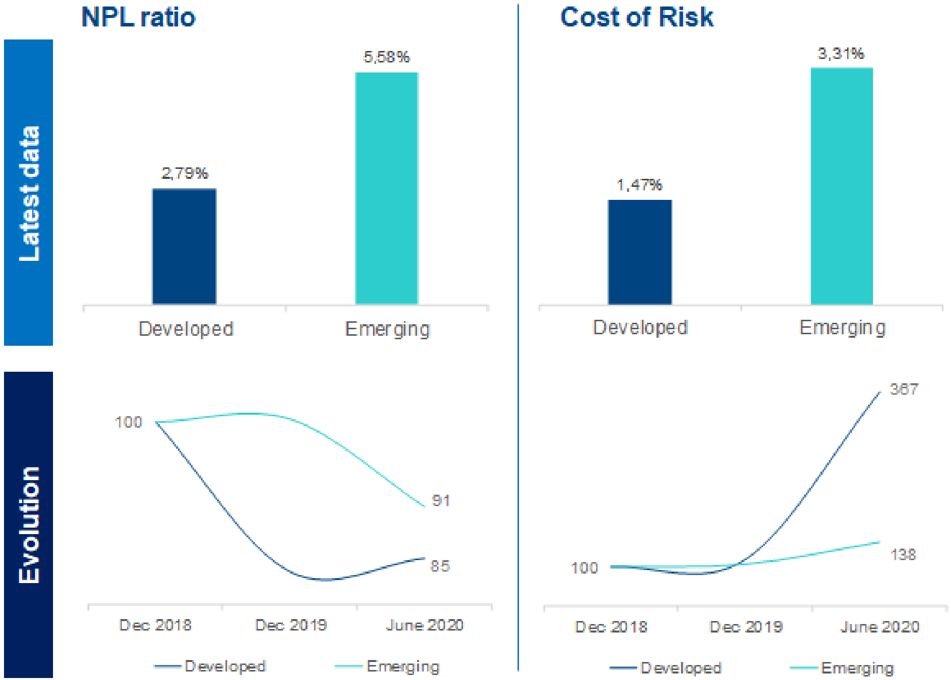
Profitability: very weak in DM and declining in EM



- Profitability measures are much higher in EM; NIM, ROA and other profitability ratios (risk-adjusted NIM, ROE and pre-provision income / ATAs) are 2-4 times higher in emerging countries.
- Among DM, Spain and USA show higher earnings capacity
- In 1H20 banks in DM anticipated loan-loss provisions more than in EM
- The reduction in profitability was stronger in EM

Developed: Spain, France, Germany, Italy, US and UK. Emerging: Colombia, Mexico, Peru, Turkey and Brazil. 5 largest banks in each country on a consolidated basis
Source: BBVA Research based on Bankscope

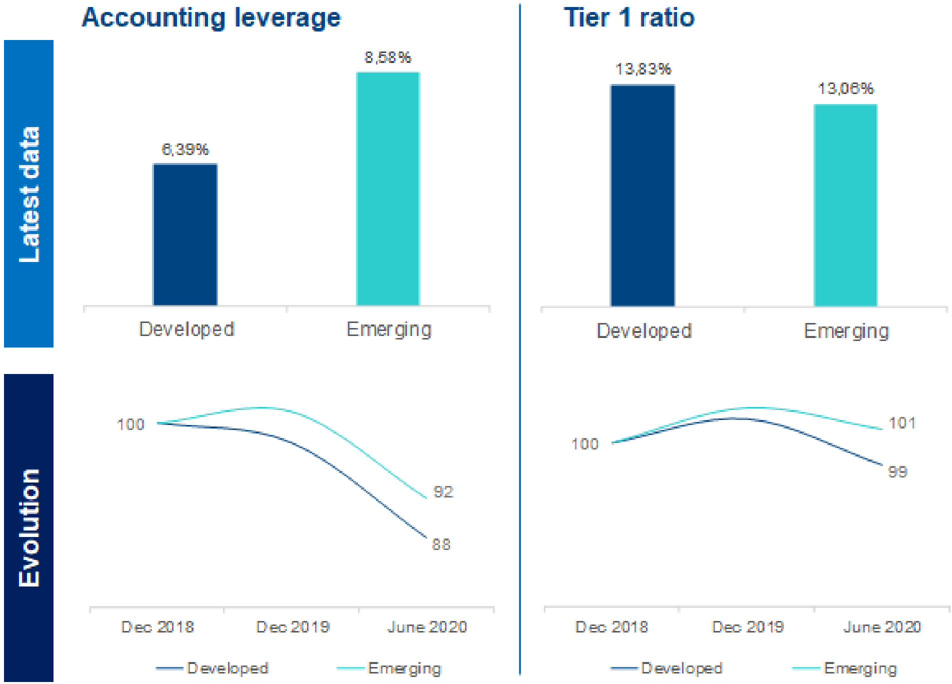
Asset quality: no signs of deterioration so far but NPLs will rise



- In DM, Italy has the highest ratio although falling since 2018. In EM, Brazil fares worse than other countries, showing a higher NPL ratio and lower coverage.
- In DM, CoR and Loan-loss provisions / Pre-provision income ratios have increased 3 times faster than in EM.
- NPL coverage has improved in all countries and is above 100% in most EM.

Developed: Spain, France, Germany, Italy, US and UK. Emerging: Colombia, Mexico, Peru, Turkey and Brazil. 5 largest banks in each country on a consolidated basis
Source: BBVA Research based on Bankscope

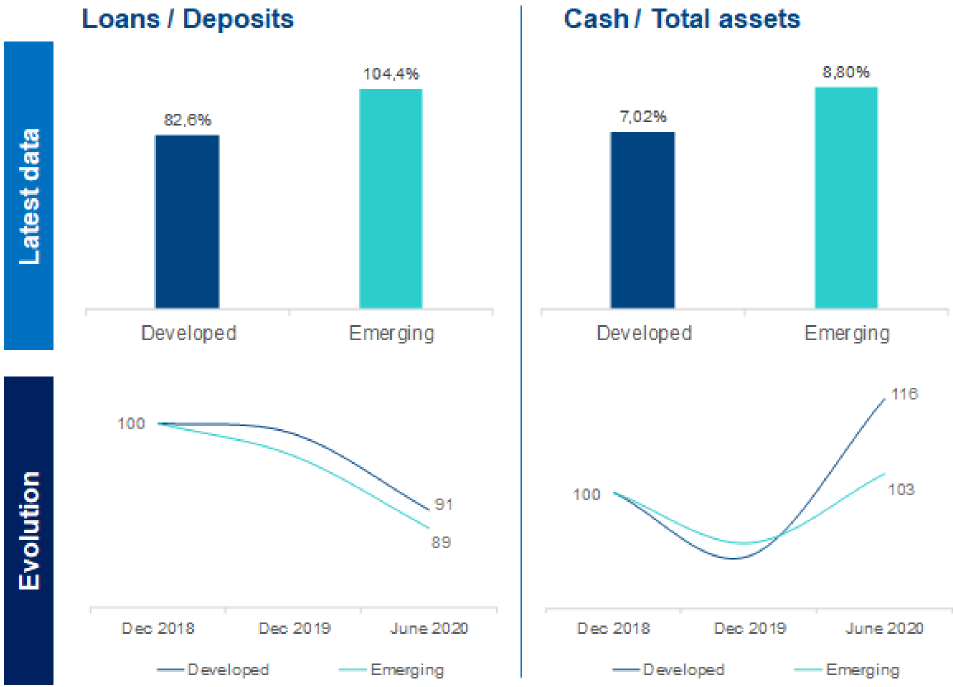
Solvency indicators remain comfortable



- So far, stability in regulatory ratios
- Accounting leverage has increased across the board
- EM typically have more equity, but also higher RWA density leading to similar regulatory capital ratios
- All countries have reduced their RWAs in response to the crisis (strategy or forbearance, or both)

Developed: Spain, France, Germany, Italy, US and UK. Emerging: Colombia, Mexico, Peru, Turkey and Brazil. 5 largest banks in each country on a consolidated basis
Source: BBVA Research based on Bankscope

Liquidity: not an issue, but cash is hoarded



- Customer deposits have increased in most countries, both DM and EM
- In all cases deposits have grown much faster than loans despite the loan guarantees put in place by the governments in many countries
- Liquid assets and especially cash has been hoarded since December 2019, breaking the trend observed last year. This was clearer in DM

Developed: Spain, France, Germany, Italy, US and UK. Emerging: Colombia, Mexico, Peru, Turkey and Brazil. 5 largest banks in each country on a consolidated basis
Source: BBVA Research based on Bankscope

Conclusion of the metric analysis

Emerging countries' banks

- Have a slightly better efficiency ratios and much higher profitability levels due to wider customer spreads and higher official interest rates (although declining). Their higher profitability ratios allows for a heavier cost structure.
- Sluggish recognition of loan-loss provisions so far. The increase in NPLs will be inevitable and banks in these countries, on average, may not be totally prepared for it. There are important challenges ahead.
- Higher accounting capital ratios, but expected increase in loan-loss provisions may erode emerging banks' solvency.

Developed countries' banks

- Lean costs in general. During the past few years (especially since interest rates are in negative territory) banks in developed countries have cut costs as a strategic priority.
- They have sped-up the recognition of loan-loss provisions in the first half of 2020 in anticipation of the expected deterioration of the economic activity due to the COVID crisis.
- Interest rates are still the driving factor behind the low profitability of developed banks.

Research

03

Short and medium term outlook

Creating Opportunities

Seven key factors are key to assess banking sector evolution after the COVID crisis (navigating its aftermath)

Factors

1 Monetary policy: low interest rates for longer

2 Digitalization: impulse to banking sector transformation

3 Regulation: lower regulatory pressure?

4 Economic growth: gap with pre-pandemic levels for some time

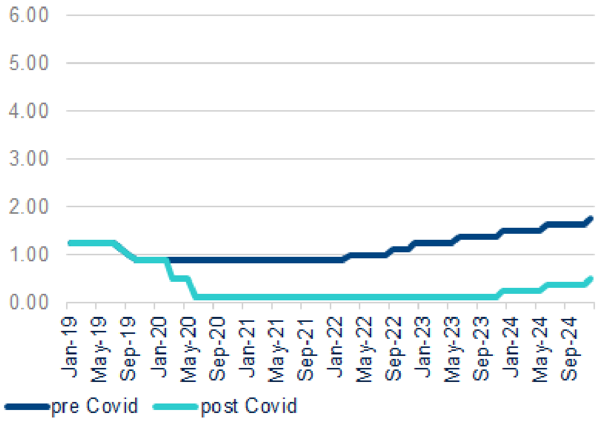
5 Entrants: Bigtech firms and fintechs expand at a quicker pace

6 Competitive landscape: Promotion of banking consolidation

7 Government support: Positive despite an uncertain phase-out but there are long term issues to be dealt with

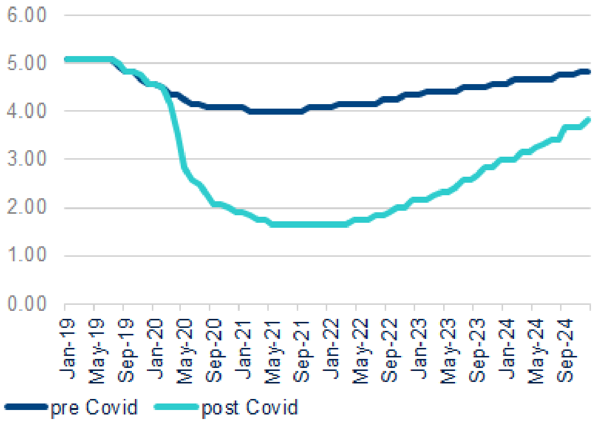
1. Monetary policy: Low interest rates for longer. Some EM close to ZLB

KEY INTEREST RATES LEVEL: AVG. DEVELOPED MARKETS (%)



*Avg: US and EZ

KEY INTEREST RATES LEVEL: AVG. EMERGING MARKETS (%)



*Avg: MX, COL and PER

- Net interest margin compression in countries that lowered rates. Banking systems which are very dependent on net interest income will suffer the most. A flattened yield curve is very damaging for the banking business; flat yield curves for longer.
- The elimination or reduction of financial tensions and the overall loose financial conditions through liquidity providing are supportive for banks and borrowers. But long term, challenges of these policies (and trade offs) will become explicit.

2. Digitalization in banking: innovation and adoption gain speed due to Covid; opening opportunities to reduce costs and boost revenues

	Shift in preference	Cost-reduction needs	Shift in teleworking	New business models
Short term	Renewed boost in banks investment to accelerate digital solutions for customers that have boosted digital interactions (D)	Digitization of processes ...and new ways to measure and price risks (Big data and AI) (S)	Covid force banks to implement alternatives for remote work at a faster pace, including infrastructure & equipment (S) (D)	Digital platforms rise as pandemic-resilient business models...how will bank's products and services be deployed? (S)
Medium term	New and more valuable services and larger customer base should boost banks revenues	Efficiency gains, partially offsetting lower profitability and perhaps improvement in credit quality assessment,	Operational resilience and efficiency and productivity gains, but employees must be trained to adapt to the "new normal"	Shift toward a "full menu" of products and services for clients (but "who" has access to the client: banks or others?)

D Demand effects

S Supply effects

3. Regulation: overall lower regulatory pressure

Short term

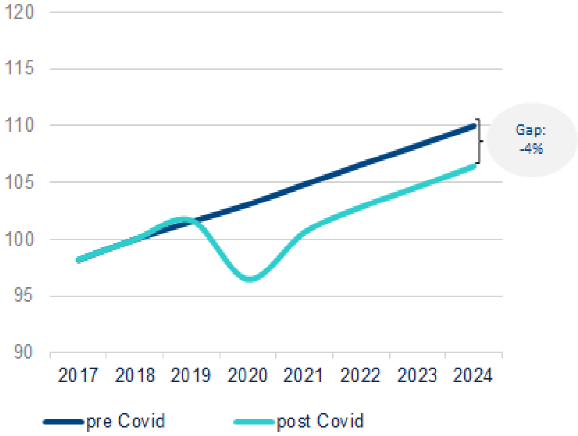
- Very supportive but there is the challenge of a potential early withdrawal (eg. capital buffer rebuilding)
- Policy short-term trade-offs between financial stability and, eventually, transparency/recognition of losses (timing and success of measures taken?)
- Inconsistencies between home/host regulations (eg. payment holidays)
- Further development and strengthening of the resolution framework (some banks will face problems) … and its use
- Stress testing - continue to be a key tool - incorporating new dimensions (operational risks, cyber risks, climate risks,...)

Medium/Long term

- Uncertainty regarding the coherence, interaction and impact of multiple regulations (at play now!)
- Recalibration of prudential framework: less structural capital and more countercyclical capital buffers.
- More attention to Non-Banks, Fintech, BigTech (level playing field needs to be a priority in the agenda!)
- Coordination prudential regulation & competition policies
- Global coordination remains imperative
- Authorities´ renewed interest on CBDC options and on the regulation of digital currencies will play out somehow

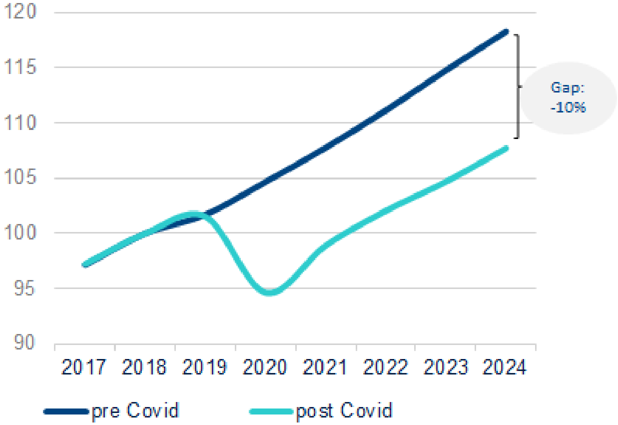
4. Economic growth: A long way to get back to pre-pandemic levels of activity. Growth differential between DMs and EMs diminish in the long run

GDP LEVEL: AVG. DEVELOPED MARKETS* (LEVEL: YEARLY, INDEX)



*Avg: US and EZ

GDP LEVEL: AVG. EMERGING MARKETS*(LEVEL: YEARLY, INDEX)

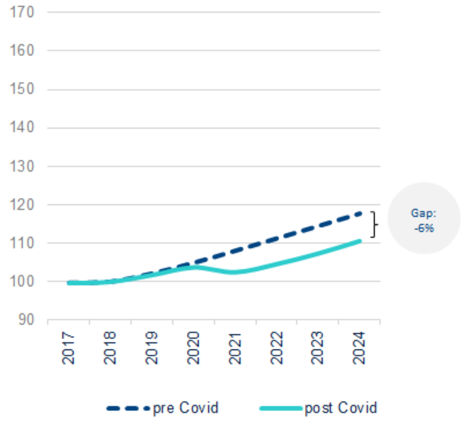


*Avg: MX, COL and PER

- After a deep recession both in DM and EM, we expect a rebound in global GDP growth next year. The growth gap post-Covid is larger in EM than DM.
- A delay in the recovery (e.g, a resurgence of the virus or a premature withdrawal of policy support) would be negative for the economic outlook and the banking sector (i.e. lower volumes, more provisions).

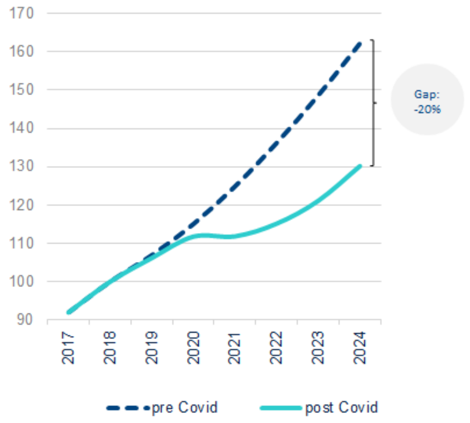
4. Economic growth: slower credit growth, especially in emerging countries

TOTAL CREDIT: AVG. DEVELOPED
(LEVEL: YEARLY, INDEX)*



*Avg: US and SPN

TOTAL CREDIT: AVG. EMERGING
(LEVEL: YEARLY, INDEX)*

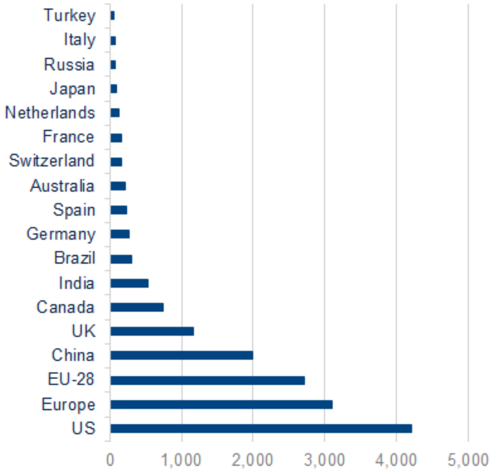


*Avg: MX, COL and PER

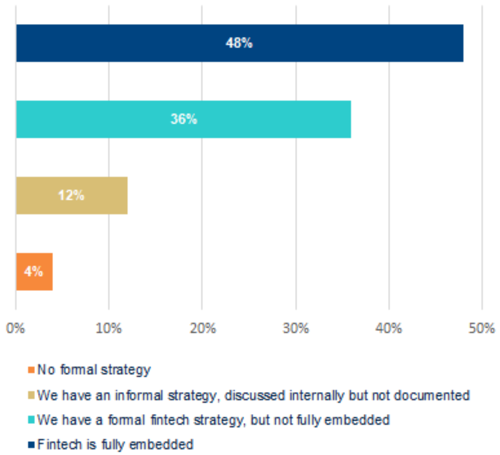
- Despite a larger gap in EM than in DM, growth in credit volumes will still be higher in EM.
- Efforts have been made to keep the flow of credit steady, avoiding a more negative scenario, but … income losses will negatively impact leverage capabilities for affected households and firms, slowing credit growth rates in coming years, mostly in emerging countries.

5. New entrants: Covid-19 should encourage fintech activity

FINTECHS BY COUNTRY 2019
(NUMBER OF FIRMS)



IS FINTECH PART OF YOUR STRATEGY? (SURVEY OF 248 FINANCIAL SERVICES FIRMS, %)

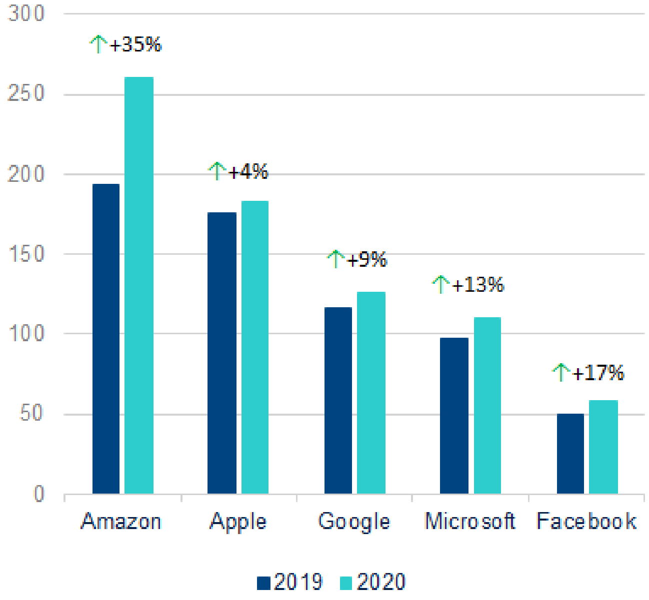


- Fintech activity and ecosystems will likely expand at a faster pace due to the pandemic.
- Comprehensive regulations (sandboxes) should encourage entry, although it is still to be seen.
- Banks have already embraced fintech, mostly as enabler partners rather than competitors:
  - A sizable share of financial services firms reports strategies to embed fintechs
  - Large corporations are more likely (53%) to have fully embedded fintechs

Source: BBVA Research, based on Bank of Spain Revista de Estabilidad Financiera (nº 38. Spring 2020) and PwC Global Fintech Report 2019

5. New entrants: Bigtech players are the largest challenge for banks

REVENUES GROWTH OF BIGTECH DURING PANDEMICS (USD BN; % YOY)*



*Accumulated revenues as of 3Q
Source: BBVA Research based on Bloomberg data

- Despite increasing scrutiny worldwide, tech giants appear as Covid-19 winners.
- Authorities are actively discussing new regulation and reform to competition law to curb Bigtech´s (mis)behaviour:
  - Gatekeepers abuse of power hindering competition
  - Privacy and fake news lack of accountability
- Bigtech is not pursuing deposit-banking ... yet: Bigtech incipient activity in financial services are mainly related to payment solutions, digital moneys and distribution of credit (ex. China's Alibaba - Ant Group...facing regulatory changes now).
- Bank's low profitability in the short term may hinder the entrance of Bigtech in the banking business. However, they have the size, know-how and financial muscle to do it.
- Bigtech banking remains a policy challenge and full of question marks in the medium term: (i) Financial stability trade-offs;(ii) Data and regulatory gaps;: (iii) Limit their activity in credit markets?(iv) Towards a run-free banking system?.

6. Covid will promote consolidation in the banking sector

Short term

- Bank profitability has been very low, which has been exacerbated by the COVID crisis
- Poor earnings estimates in all jurisdictions
  - Lower revenues
  - Higher loan-loss provisions
- Huge impact on banks' share prices and valuation metrics

Medium/Long term

- Will the current l concentration levels in most countries increase?
- Regulators seem to favor further consolidation (M&A) as a way to strengthening the banking systems: financial stability

Consolidation is one lever to increase efficiency and improve profitability

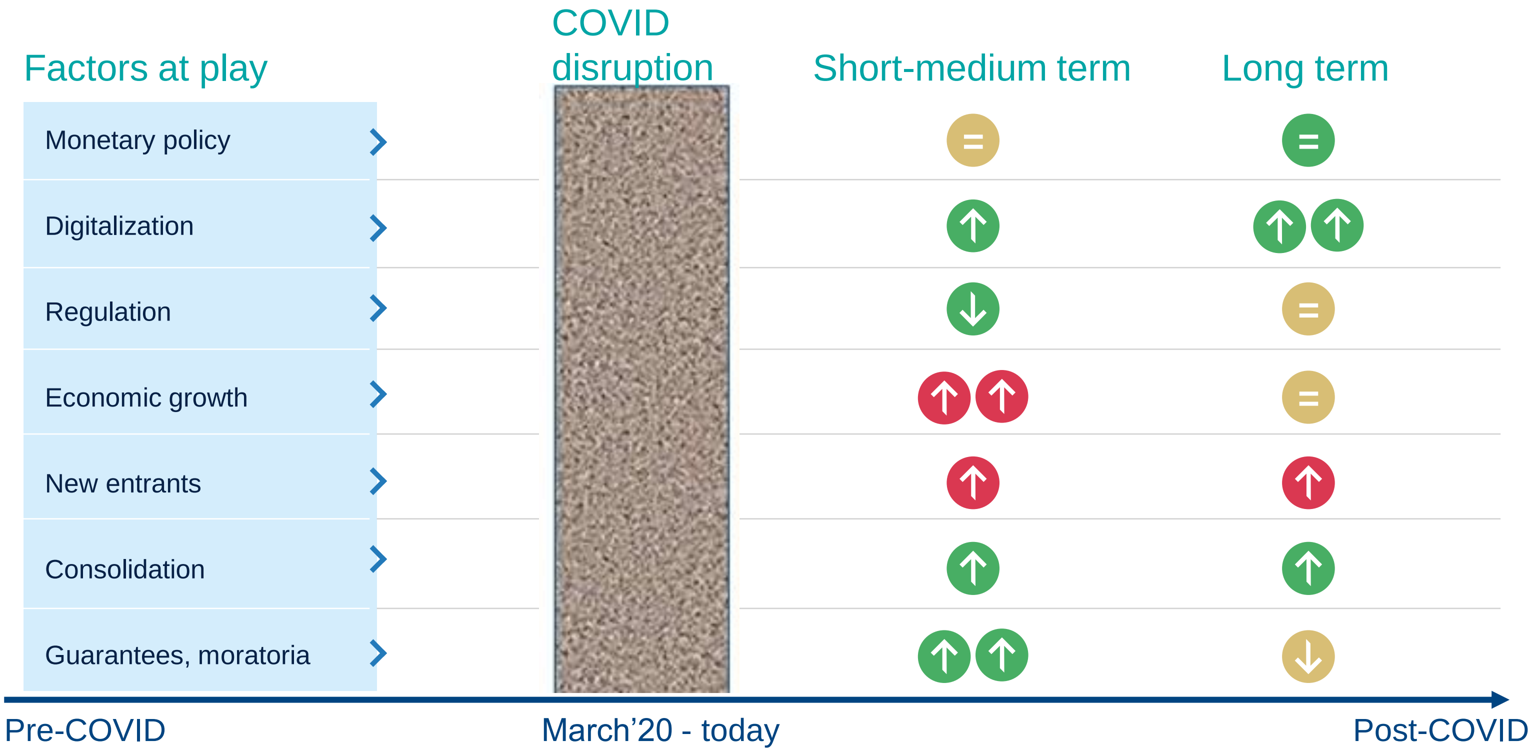
Growth deals:
in search for revenue growth and GDP diversification
Mainly in EM

Defensive deals:
in search for cost-cutting to improve profitability
Mainly in DM

7. Government support measures are certainly positive, but uncertainty looms after phase-out and will need to be addressed

	Short term	Medium/Long term
Government credit guarantees	▪ Support new credit; in fact, corporate credit grew faster ▪ Contains NPLs formation (until activity resumes) ▪ Second wave could trigger programs' extension a	▪ Burden sharing and its effective articulation. IMF says lower provisions could add 176/ 67bps k in EM/DM ▪ Phase-out should be linked to restructuring programs or funding new investments. Special relevance for DM where it will be a key element of the recovery
Moratoriums	▪ NPL ratio stable or even going down. Lower provisions but reduces interest revenues ▪ Cure: A high proportion of up-to-date in payments. Many moratoriums ended. Second wave could trigger extensions ▪ Lack of transparency on banks' balance sheets	▪ Trade-off between duration of moratoriums and non-payment culture ▪ Difficulty on definition viable/non-viable business. Risk of keeping zombie firms ▪ Avoid a cliff effect on asset quality
Other Government Support (direct transfers)	▪ Alleviate financial burden. DM have invested higher amounts than EM (due to a major fiscal space) ▪ Banks have benefited indirectly from these measures	▪ Need of targeted programs designed for COVID most impacted sectors/ groups

Wrap-up: some factors will intensify and some will moderate



Right-hand side arrows show an intensification (up) or a reduction (down) of the factors’ relevance compared to pre-COVID period

Examples: The factor’s relevance is expected to increase, and its impact on banking is positive

The factor’s relevance is expected to remain the same, and its impact on banking is unclear

Short-term challenges for the banking sector

Asset quality

- Deterioration in firm's' financial position - how to facilitate and deal effectively with debt restructuring? Challenge to distinguish viable from non-viable companies
- Inevitable increase in NPLs. How to resolve them to avoid their accumulation in banks' balance sheets for a long time?
- Debt overhang and need to strengthen capital position of borrowers

Profitability

- How to remain profitable? Profitability challenges will be greatest where already weak

Key issues for banks after COVID: Debt restructuring and NPL resolution

Debt restructuring
Main objective: Avoid firms shutting down

NPLs Resolution
Main objective: Avoid impaired balance sheets

Public/private collaboration

Debt restructuring

Principles/Necessary conditions

- Anticipation/proactivity
- Distinguish viable/non-viable businesses and debt
- Burden sharing private and public
- Share best practices (Code of conduct?)
- Efficient frameworks (out-of-court, temporary express resolutions, adjust insolvency laws)

Different options

- Solvency support instruments (eg. sector specific; private specialists, platforms combining public/private capital; public capital for strategic sectors)
- Loss recognition: write-off non viable debt
- Debt conversion to capital (who decides, who invests?)
- State support

NPLs Resolution

Principles/Necessary conditions

- Involve specialised asset managers
- Adequate prudential and accounting treatment
- Law enforcement - increase recoveries
- Burden sharing - recognise losses
- Quick disposal: avoid legacies & zombie firms

Different options

- Outright sales of NPLs
- Securitisations of NPLs
- Asset management companies
- Platforms (private/public or both) for NPLs

Key features for post- COVID winners

1. Embrace digitalization	2. Adapt to clients' needs	3. Efficiency is paramount	4. Revenue diversification
Facilitate digital transition to customers	Develop a "full menu" of banking services	Cost control is key…but so is revenue growth	Promote fee-based business….but interest revenues will remain essential
Transformation of distribution channels	Clients should decide how to be served by banks	M&A may bring about efficiency gains	Diversification (products/markets) to take advantage of different recovery speeds, supported by digitalization
Help employees adapt to the new way of providing service	Personalized support will remain essential	Focus on core and strategic business. Sale of non-core assets	Partnerships with Fintech/Bigtech

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